

The Wall Street Collapse and Return of Reality-Based Economics

ROBERT POLLIN

Over the past generation, the U.S. economy as well as most of the rest of the global economy have been dominated by the idea that free market capitalism produces dynamic growth, financial stability, and as close as we are likely to come to a fair society. Supporters of this pro-market framework hold that government interventions to encourage growth, stability, or even fairness will almost always produce more harm than good. This mode of thinking has been the intellectual foundation for the era of financial deregulation in the United States—the dismantling of the Glass-Steagall regulatory system that was built amid the rubble of the 1929 stock market crash and ensuing 1930s Depression. The Clinton administration provided the final nails in the coffin of financial regulation with the passage of the Financial Services Modernization Act in 1999.

Writing in July 2010, in the recent aftermath of the most profound financial market crisis since the 1930s, it is clear that the case in behalf of unregulated financial markets has collapsed as decisively as did the markets themselves. The crisis would have been far worse still, if not for the massive government bailout operations that propped up both the financial system and total spending in the economy.

Moreover, the 2008-09 collapse was no mere aberration. Financial crises have been a regular feature of the United States and global economic landscape since the push to deregulate began in earnest in the late 1970s. Consider the scorecard over the twenty years prior to the 2008-09 disaster: a stock market crash in 1987; the Savings and Loan crisis and bailout in 1989-90; the “emerging markets” crisis of 1997-98—which brought down, among others, Long-Term Capital Management, the super hedge fund led by two economics Nobel laureates specializing in finance—and the bursting of the dot-com stock

ROBERT POLLIN (pollin@econs.umass.edu) is a professor of economics and co-director of the Political Economy Research Institute (PERI) at the University of Massachusetts-Amherst. His books include *New Perspectives in Monetary Macroeconomics: Explorations in the Tradition of Hyman P. Minsky* (coeditor, 1994) and *Contours of Descent* (2004).

This is a review of John Cassidy’s *How Markets Fail: The Logic of Economic Calamities* (New York: Farrar, Straus and Giroux, 2009), 400 pages, \$28.00, hardcover.

market bubble in 2001. Each of these crises could have produced a 1930s-style collapse in the absence of full-scale government bailout operations. Moreover, as Charles Kindleberger makes abundantly clear in his classic study *Manias, Panics, and Crashes*, such crises had been part of the regular rhythms of capitalist economies prior to establishment of the Glass-Steagall regulatory system in the United States and comparable regimes in other advanced economies.

John Cassidy's new book *How Markets Fail: The Logic of Economic Calamities* is an important contribution to an already hefty stack of books, reports, dissertations, and manifestos that attempt to explain what went so badly wrong this time around. Like many of the best contributions to this new literature, Cassidy provides an illuminating narrative of the causes of the crisis, including discussions of the real estate bubble, the subprime mortgage market, the markets for derivative financial instruments, and how this whole edifice of high-tech, turbo-charged financial engineering, constructed by the cleverest Wall Street minds, came crashing down. Cassidy also explains how most of the major-domo financial market players—Goldman Sachs, Citibank, J.P. Morgan and a few others—managed to get themselves bailed out by the U.S. Treasury and Federal Reserve. The alternative at the time—given that a radical restructuring of the financial system was not a feasible short-term solution—was allowing hundreds of millions of innocent people to experience even more dire effects from Wall Street recklessness.

In telling the story of the crisis, Cassidy reserves special scorn for Alan Greenspan, the Chair of the Federal Reserve from 1987 to 2006, who pushed the case for financial deregulation relentlessly while in office, even though he himself had directed multiple financial bailout operations to stave off the worst effects of the steady dismantling of Glass-Steagall. Greenspan fully earned Cassidy's opprobrium, but it was still unfair to single him out. Certainly, Robert Rubin and Larry Summers, who both served as Treasury Secretary under President Clinton, were equal coconspirators with Greenspan in pushing the deregulation agenda under Clinton. On top of this, from the 1970s onward, large majorities from both the Democratic and Republican parties were happy to endorse whatever deregulation agenda Wall Street would draft on their behalf. Jumping forward to the present, perhaps the single most costly mistake to date of the Obama presidency was to put the same Larry Summers in charge of economic policy, with several other Robert Rubin acolytes also occupying important positions.

Focus on Economic Theory

What sets Cassidy's book apart from the rest of the new literature is not his narrative per se of any aspect of the crisis, but rather his decision to frame his book within the context of debates about economic theory. Indeed, the book is divided into three sections, with only the final third focusing on the events of 2007-09. The first third of the book is on orthodox pro-free market economic theory, what Cassidy calls "utopian economics." The term fits, because, as Cassidy makes clear, the only way economic theorists can reach the conclusion that free market capitalism is a viable system is through making heroic—i.e., "utopian"—assumptions about human behavior and by ignoring hundreds of years of historical evidence.

In the middle third of the book, Cassidy then surveys what he terms "reality-based economics." This section covers various strands of economic thinking that provide explanations as to why the operations of free market capitalism frequently break down. John Maynard Keynes is certainly the towering figure among twentieth century contributors to this group, and Cassidy does a good job in describing Keynes's work. But Cassidy's discussions in this section range widely around several issues, including environmental protection and the market for used cars, in addition to his main concern, the operations of financial markets.

The first broad point to emphasize about these first two sections of the book on economic theory—comprising sixteen chapters in all—is that they are not dry and intimidating, contrary to what one might fairly anticipate through having perhaps sat through an introductory economics course or dipped into most of the standard textbooks. Rather, Cassidy's writing in these chapters is clear and lively. Among other features, these sections include biographical sketches of many of the leading contributors to the economic theory literature, in the manner of Robert Heilbroner's classic work *The Worldly Philosophers*. Thus, Cassidy correctly devotes lots of attention to Milton Friedman, without question the most influential exponent of free market economics in the twentieth century. But Cassidy also discusses Friedman's close ties to the fascist government in Chile, which came to power in 1973 in a violent coup that overthrew the democratically elected government of the country's first socialist president, Salvador Allende.

But the most significant and surprising feature of Cassidy's theoretical chapters is that, to my knowledge, he is the first widely read commentator to give the great financial macroeconomist Hyman

Minsky and the equally great Marxist economist and *Monthly Review* founding coeditor Paul Sweezy their due, as two of a tiny handful of people who recognized and warned about the patterns of rising financial fragility that would, in time, produce the disasters of 2008-09. Thus, Cassidy offers a sense of vindication for longtime readers of MR such as myself, relative to the marginalization experienced by Sweezy and his MR coauthor and coeditor Harry Magdoff, during the 1970s and 1980s, when they were publishing the first main wave of articles on finance in MR. These outstanding articles were subsequently collected into books, including *The End of Prosperity* (1977) and *Stagnation and the Financial Explosion* (1987).

Overall then, *How Markets Fail* is a work of considerable scope, offering fresh perspectives on a wide range of topics through all twenty-three chapters. But Cassidy does also weave together the various strands of the book into one overarching narrative, which is just how abysmally “utopian economics” has served as an analytic framework for managing contemporary financial markets. This is even while “reality-based economics,” including Minsky and Sweezy at the top of the heap, have long been available but neglected resources for understanding how to create stable financial markets.

From Utopian Economics to Neoliberalism

In reading Cassidy’s full-bore attack on utopian economics, it is easy to forget just how thoroughly this approach was able to dominate economic theory and policy making throughout the world since the 1970s until the 2008-09 crisis, and even today has surrendered only small pieces of territory. After all, this approach is the cornerstone of what has come to be known as *neoliberalism*, the one-size-fits-all economic policy model that insists the free-market agenda is always superior to government interventions, except in situations where big business and big finance require government life supports.

As Cassidy discusses, there have been three giant figures of neoliberal economics in the recent past: Friedrich Hayek and Robert Lucas, in addition to Milton Friedman, all of them Nobel laureates in economics. As far back as the 1930s, Hayek made a name for himself by arguing that socialist economies, even ones that provided wide scope for market interactions as well as government planning, were doomed to fail. This is because, without allowing for freely operating, rough-and-tumble, hard-bargaining markets—not the weak imitation version that would emerge within the steel trap of a planned socialist economy—people would be unable to

obtain the information they need to make effective economic decisions. Hayek's arguments were broadly neglected when he first advanced them, but he gained immense prestige after Soviet-style socialism collapsed in 1989. After the Berlin Wall fell, even many leftists came to conclude that, in light of the historical experience, Hayek had gotten the best of Oskar Lange, a Polish socialist and eminent University of Chicago economist in his own right, in their famous debates on the viability of market socialism.

Hayek did offer important insights on the role of markets as effective information-processing machines. But Hayek's rendition of this issue was typically one-sided—indeed “utopian”—because it ignored all the ways this machine was prone to failure. As Cassidy discusses at length, in the real world, people almost always make decisions in their marketplace transactions based on incomplete or otherwise distorted information. An important recent example of this was the experience of millions of U.S. homeowners who took out subprime mortgages without understanding that their interest payments would rise sharply a year or so after they initially accepted the loan at very low “teaser” rates. Moreover, even if we do have accurate market information, our cognitive abilities to process this information are also limited. Several researchers discussed by Cassidy, including Joseph Stiglitz, George Akerlof, Herbert Simon, and Daniel Kahneman, have been awarded economics Nobel prizes for developing important insights on these issues.

But the most spectacular failure within the pantheon of utopian economics has to be Robert Lucas. Lucas followed Milton Friedman, both as the pacesetter at the University of Chicago and as the most influential neoliberal macroeconomist of his generation. In the early years of my own career teaching graduate macroeconomics in the 1980s, Lucas was regarded as the absolute gold standard among young mainstream macroeconomists. This group of people clung firmly to the view that if you and your students were not somehow regurgitating Lucas, then you weren't doing serious economics. As Lucas himself observed in 1980, “One cannot find good under-forty economists who identify themselves or their work as Keynesian....At research seminars, people don't take Keynesian theorizing seriously anymore; the audience starts to whisper and giggle to one another.”

But for anyone who entered the field to try to think seriously about the world as opposed to just following the fashions of the time, it was obvious from step one that the Lucas model was extreme. This becomes clear in following, for example, his highly influential analysis explaining the futility of monetary policy interventions as a means of reducing

unemployment in a recession. To begin with, Lucas assumed that people carried in their heads a fully worked out and accurate model of how the macro economy functions. In the event that the Federal Reserve tried to stimulate the economy and expand job opportunities by lowering interest rates, all rational people, working with the accurate macroeconomic models in their heads, would know that this initiative would end up causing inflation. More precisely, they would calculate how much inflation would be produced by the Fed's intervention, and as such, they would also know that this acceleration of the inflation rate would erode how much they could buy at the given wage they were being paid. The workers would therefore realize that they would be foolish to deliver the same level of work effort until their wages were raised to compensate them for the rise in inflation. The unemployed would similarly refuse job offers whose wages did not account for the erosion of their buying power that would result through the inflation that they would have accurately anticipated.

I remember in the 1980s challenging my Ph.D. students to help me carry out accurately even one of the multiple calculations Lucas claimed anybody could and did perform on a regular basis. Needless to say, we all failed the assignment, and I have no doubt that Lucas himself would also have failed. The reason was simply that there was no possible way anybody could know all the things that Lucas blithely asserted everyone knows as a matter of course. Has there ever been a major intellectual leader so completely out of touch with the realities outside his office door, or even inside his own head?

Nevertheless, Lucas's assertions on the super-calculating capacities of unemployed people served an important purpose: it was the foundation for his conclusion that any effort by the government to create jobs would inevitably fall on its face, and only produce higher inflation. From the Lucas perspective, the good news about his conclusion as to the futility of government policy interventions was his other main conclusion that, always and everywhere, such interventions were unnecessary, since the free market could maintain economic growth and full employment on its own.

Minsky, Sweezy/Magdoff, and Reality

As against the abject failure of Lucas and his cohort, Hyman Minsky, from the 1950s until his death in 1996, built an analytic framework that explained how unregulated financial markets will always produce instability and crises. Cassidy selected well in establishing Minsky's model as the analytic centerpiece of his book.

As Cassidy describes, the key for Minsky in understanding financial instability is to trace the shifts that occur in investors' psychology as the economy moves out of a period of financial crisis and recession or depression, and into a phase of rising profits and growth. Coming out of a crisis, investors will tend to be cautious, since many of them will have been financially clobbered during the just-ended recession. For example, they will hold large cash reserves as a cushion to protect against future crises.

But as the economy emerges from its slump and profits rise, investors' expectations become increasingly positive. They become eager to pursue risky investment ideas such as securitized subprime mortgage loans. They also become more willing to let their cash reserves dwindle, since idle cash earns no profits, while purchasing speculative vehicles such as subprime mortgage securities that could produce returns of 10 percent or higher.

But these moves also mean that investors are weakening their defenses against the next financial downturn. This is why, in Minsky's view, economic upswings, proceeding without regulations, inevitably encourage speculative excesses in which financial bubbles emerge. Minsky explained that, in an unregulated environment, the only way to stop financial bubbles is to let them burst. Financial markets then fall into a crisis and a recession or depression ensues.

Here we reach one of Minsky's crucial insights—that financial crises and recessions actually serve a purpose in the operations of a free market economy, even while they wreak havoc with people's lives, including those of tens of millions of innocents who never invest a dime on Wall Street. Minsky's point is, without financial crises, a free market economy has no way of discouraging investors' natural proclivities towards ever-greater risks in pursuit of ever-higher profits.

However, in the wake of the calamitous 1930s Depression, Keynesian economists tried to design measures that could supplant financial crises as the system's "natural" regulator. This was the context in which the post-Second World War system of big government capitalism was created. The package included two basic elements: regulations designed to limit speculation and channel financial resources into socially useful investments, such as individual-family housing; and government bailout operations to prevent 1930s-style depressions when financial crises broke out anyway.

Minsky argues that both the system of financial regulations and the bailout operations were largely successful. That is why, from the end of the Second World War to the mid-1970s, financial markets, in the

United States and globally, were much more stable than in any previous historical period. But even during the New Deal years themselves, financial market titans were already fighting vehemently to eliminate, or at least defang, the regulations. By the 1970s, almost all U.S. politicians—Democrats and Republicans alike—had become compliant. For Minsky, the consequences were predictable.

Minsky's Wall Street paradigm did not address all of the afflictions of free-market capitalism. In particular, his model neglects the problems that arise from the vast disparities of income, wealth, and power that are just as endemic to free market capitalism as are its tendencies toward financial instability.

This is where the work of Sweezy and Magdoff begins to fill a gigantic hole. As regular readers of MR know well, the Sweezy/Magdoff analysis of financialization was closely tied to their broader framework explaining how advanced capitalism faced chronic problems of insufficient overall demand and, correspondingly, inadequate profitable investment opportunities. From their perspective, financialization of the economy—including the encouragement of speculative bubbles—was the primary means through which capitalists could create new investment opportunities for themselves. As Sweezy and Magdoff wrote in MR as early as 1987, "Is the casino society a significant drag on economic growth? Absolutely not. What growth the economy has experienced in recent years, apart from that attributable to an unprecedented peacetime military buildup, has been almost entirely due to the financial explosion."

As with Minsky, Sweezy and Magdoff also did not develop a fully adequate framework for understanding financial bubbles and crises. There are significant holes and deficiencies in both approaches that need to be worked through by other researchers, as is true with all meaningful research programs. But this brings up a larger question: why, over the past thirty years, were something on the order of 90 percent of professional macroeconomics economists working on aspects of the Friedman/Lucas framework, while less than 1 percent were developing the Minsky/Sweezy approach? Cassidy, unfortunately, ignores this question, perhaps because the answer is obvious. Whatever its failings in terms of intellectual coherence or relevance, the Friedman/Lucas model—and neoliberalism more generally—does an outstanding job serving interests of big business and the rich, while the Minsky/Sweezy approach challenges the legitimacy of free market capitalism and its beneficiaries. This is especially true when you make the one small adjustment to the Friedman/Lucas model, which is the key innovation of neoliberalism, as

opposed to classical liberalism. That is, neoliberalism is all for allowing the free market to rip, including especially on Wall Street, but also will not hesitate to embrace government bailouts when the inevitable financial crises emerge. Seen in this way, Wall Street bailouts are not only absolutely needed for keeping capitalism afloat; they are also central for maintaining the legitimacy of mainstream, pro-business economic theory.

Cassidy ends *How Markets Fail* with a call to arms: “Before the political will for reform dissipates, it is essential to put Wall Street in its place and to confront utopian economics with reality-based economics.” However, throughout his long, careful study, he never focuses seriously on how we might translate the insights of reality-based economics into a workable set of policies and institutions that can both rebuild stable financial systems and, more fundamentally, begin again to advance the historic project of creating sustainable democratic, egalitarian economies. This is a gap that will obviously need to be filled by a wide range of reality-based economists, alongside citizens unwilling to serve as patsies for either the grand schemes of Wall Street or the outlandish propositions of utopian economics.

MONTHLY REVIEW

Fifty Years Ago

In a capitalist society collective foresight and planning are possible only to the extent that they involve negligible present sacrifices and ultimate benefits to all or nearly all individuals who count (i.e. property owners). If present sacrifices are substantial and future benefits collective, no action is possible. The bourgeois mentality, in other words, is so conditioned that it can never transcend the horizon of individual interests. When a given historical situation seems to call for such an effort, the response is recourse to rationalization which, while distorting reality, provides the needed justification for attitudes and actions which can pass the private interest test. This analysis explains one of the most obvious and yet puzzling things about capitalist society, why it can never act in advance to forestall a crisis, no matter how predictable it may be, but must always wait and act after the crisis has occurred.

—LEO HUBERMAN and PAUL M. SWEEZY, “The Theory of U.S. Foreign Policy—I,” *Monthly Review*, September 1960